Submission

to

Treasury Retirement Income Policy Division

concerning

Retirement Income Covenant Position Paper

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Ms Rebecca McCallum
Manager, CIPRs
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600
By email mailto:superannuation@treasury.gov.au

Dear Ms McCallum,

RETIREMENT INCOME COVENANT POSTION PAPER

1. Mutual Pensions Pty Ltd (MPPL) welcomes the opportunity to make a submission in response to the May 2018 paper entitled *"Retirement Income Covenant Position Paper"* (the Paper).

2. This submission contains: -

a. an initial comment covering aspects that may not be covered in other submissions;

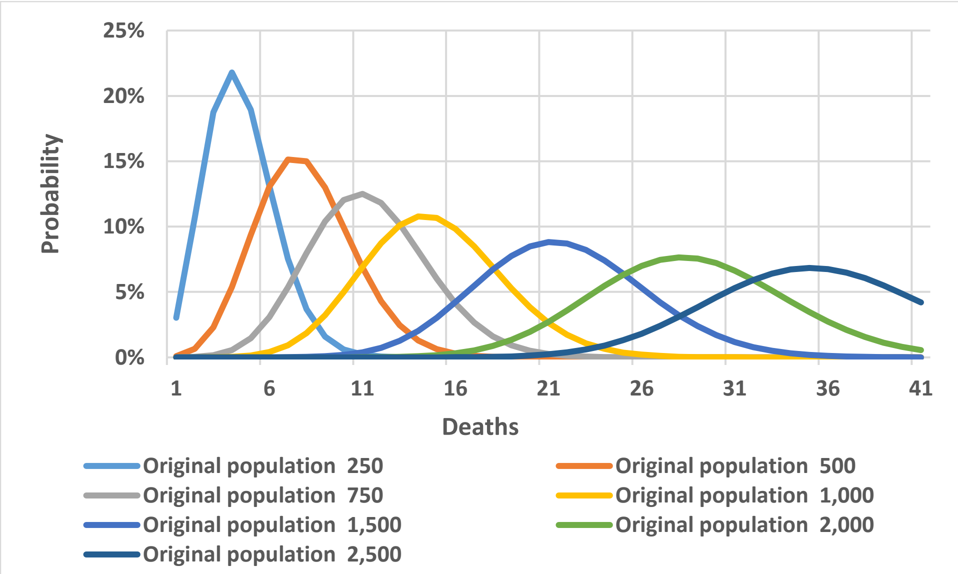
b. background information on MPPL, its product and the difficulties and impediments it has faced in trying to establish a longevity protection scheme for Australian retired people;

c. suggestions for immediate action to facilitate it and other organisations helping to achieve this and

d. comments on specific issues raised in the Paper.

Initial comment

3. While the focus of the Paper is on individual actions of funds, longevity protection, particularly for smaller funds, is better provided where there are economies of scale and large numbers of lives involved to smooth distributions. This counsels cooperation between funds or the use of third party providers. To illustrate the problem, the following chart shows the distribution of the number of first year deaths of various populations of males initially aged 67 experiencing Australian Life Table mortality rates.



4. Group Self Annuitisation (GSA) arrangements may be impractical for a very small number of members. For this reason, funds might initially want to offer GSA CIPRs that are contingent on uptake by a specified number of members within a specified time. If the required uptake does not occur, the funds would need to fall back on a guaranteed annuity. MPPL submits the legislation should recognise this. Paragraph 42 below refers

5. When one considers that the people likely to take up the offer of a CIPR are a subset of the subset of fund members who are of retirement age, it quickly becomes apparent that only large funds will be able to efficiently offer CIPRs on their owns. For this reason, MPPL urges the government to consider and facilitate the cooperation of funds or the use of third party pools as it finalises the CIPR framework. Paragraph 34 below refers.

6. The Paper is silent on sequencing risk. MPPL suggests that trustees should be obliged to consider this risk even if they ultimately decide to do nothing to mitigate it. Paragraph 22 below refers.

7. Using GSAs to provide a deferred longevity benefit overlaid on an ABP may need modification to the minimum drawing levels. Paragraph 31 below refers.

Background

8. Since 2007, MPPL has been working on a GSA concept. This has involved: -

- **a.** benefit design;
- **b.** lodgement of a patent application;
- **c.** preparation of a draft Product Disclosure Statement (PDS);
- **d.** software development dealing with data collection and storage and calculation algorithms and
- **e.** presentations to superannuation fund executives and trustees.

9. Presentations have drawn considerable interest for the concept, but no commitments to its use. The main impediments to uptake have been: -

- **a.** pressure of other work;
- **b.** legislative impediments and uncertainty;
- **c.** uncertainty about member uptake and

d. a reluctance to be first mover.

Product description

10. MPPL's product is the Mutual Pension® overlay, which sits atop an Account Based Pension (ABP). In return for accepting restrictions on drawings and forfeitures on death, participants are entitled to share in distributions arising from forfeitures of deceased other participants. Participants can pursue whatever investment policies they wish.

11. MPPL's product has two versions: -

a. the fully optioned version which has considerable flexibility in the drawings and forfeitures to apply, but, once these have been established, very limited scope to change them and

b. the default model which is trades away flexibility to render it simpler.

12. In principle, Mutual Pension® overlays can work within a single fund or across a number of funds. The multi fund mode provides an opportunity for smaller funds to "harness the power of averages"® and provide longevity protection that they might not be able to provide alone.

13. While fully optioned Mutual Pension® overlays have a great deal of flexibility, for CIPR purposes, the basic default model should be used. This has been used in the examples of this paper.

Legislative impediments and uncertainty

14. The legislative impediments and uncertainties faced by Mutual Pension® overlays hinder, complicate or render uncertain the operation of the GSA that is the Mutual Pension® overlay and, no doubt, other GSAs. In particular,: -

a. the requirement of ITAA 97 Regulation 292.25.01 that transfers from reserves in excess of 5% of a member's balance are treated as Concessional

Contributions therefore exposes members to the risk of excess concessional contribution tax;

b. SIS Regulations 5.08(1), 5.04(2) and 6.21 cast some doubt on whether balances at death can be forfeited;

c. while SIS Regulation 6.30 exempts pensions from the requirement of Regulation 6.34 to rollover of funds on request, the exemption does not extend to ABPs, casting doubt on whether it applies to an ABP subject to a Mutual Pension® overlay and any other GSA based on an ABP;

d. it is not clear that superannuation funds have the authority to draw on their reserves to transfer to another fund in the context of the multi fund Mutual Pension® overlay and

e. even if multi fund transfers are permitted, it is not clear whether they would be assessable and deductible under the ITAA and whether they would attract Goods and Services Tax, which would be unrecoverable by the receiving fund,

Immediate recommendations

15. It is MPPL's suggestion that the government announce the specific barriers to the establishment of GSA based longevity protection that it will address and remove. This will enable the industry to get on with the task of designing such systems, without having to wait for draft legislation to know which specific barriers will stay and which will go. This will break the "chicken and egg" cycle that has so far inhibited innovation in this important policy area.

16. There may be impediments not identified by MPPL, but identified by other submissions. It is important that the government's intentions in respect of all impediments be known to the industry.

17. The impediments that MPPL has identified and which it seeks clarification or rectification are: -

a. there should be no impediment to forfeiture of funds on death within the rules of a GSA scheme;

b. there should be no impediment to distribution of reserves created by the operation of a GSA scheme **within** a superannuation fund;

c. there should be no prevention of or taxation of transfers of reserves created by the operation of a GSA scheme **between** participating superannuation funds and

d. there should be no right for a member to transfer or commute funds subject to a GSA scheme out of that scheme except in circumstances where the funds are transferred to another GSA scheme with no less stringent forfeiture requirements.

General comments

18. MPPL supports the aims of the covenant as enunciated on page 2 of the Paper.

19. MPPL agrees that it is important that the Social Security treatment on CIPRs has been clarified and welcomes the changes made.

20. There is a fundamental conflict between access to capital and longevity protection. The reason is that longevity protection is predicated on forfeiture of capital. Any arrangement that allows a member to withdraw capital when their health deteriorates denies the very basis of longevity protection. While MPPL's "fully optioned" version can accommodate planned withdrawals, its "default" version cannot. Neither version can accommodate unplanned withdrawals. It is unlikely that any other CIPR can do so without jeopardising the longevity protection. In this context, a proportion of funds will need to remain in ABP s as set out in the "A+ Retirement" example of page 8 of the paper.

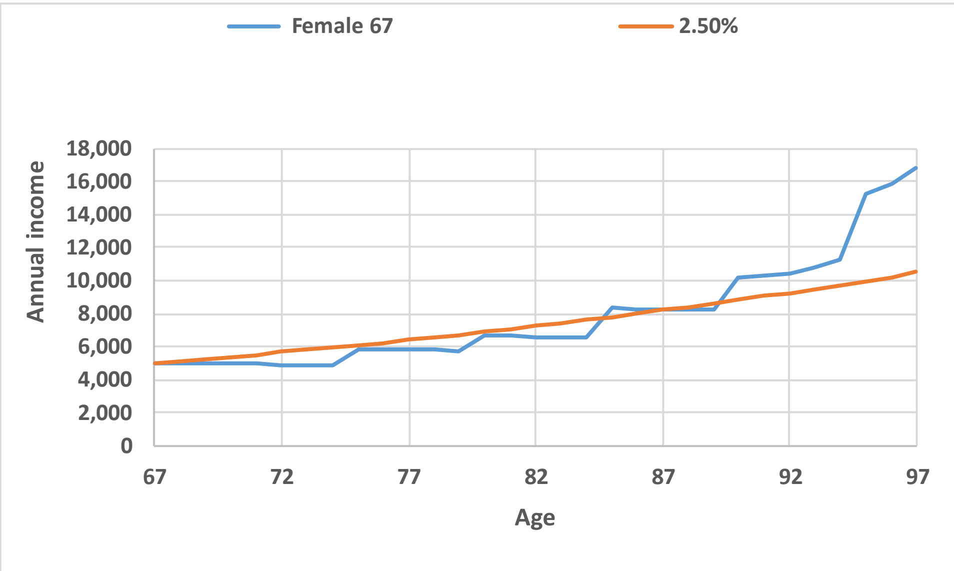
21. MPPL agrees that funds should establish a retirement income strategy and agrees with the factors listed on page 4 of the Paper.

22. MPPL notes, however, that there is no mention of sequencing risk. Sequencing risk only comes to the forefront after collapse of elevated markets. It is, nevertheless, a serious risk and needs to be included in trustees' considerations. Given the recent ten year high of the S & P / ASX 200, the time for consideration of sequencing risk may be close.

23. The waiver of the need to hold an AFSL to offer a CIPR is a worthwhile simplification. It will, however, be necessary to strongly emphasise the forfeiture aspects to avoid later troubles.

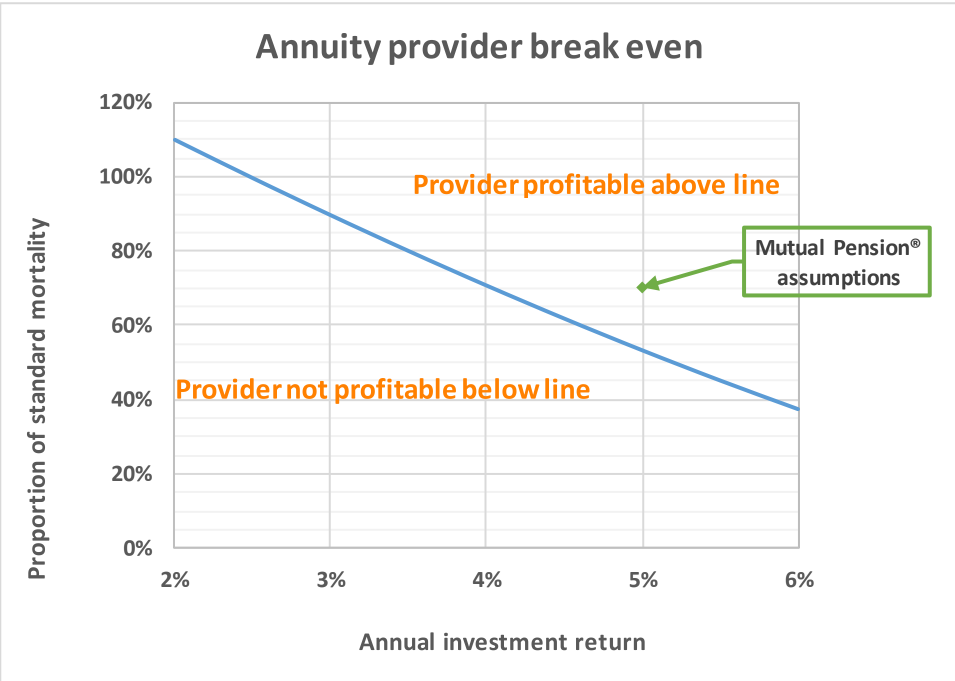
24. MPPL agrees that the sophistication of guidance tools will vary and that, beyond the default CIPR, members will need advice.

25. It is likely to be a feature of most GSA products that real income rises as age advances. This means that the concept of broadly constant income should be generously interpreted. The following chart based on the MPPL default version for a female aged 67 at commencement, illustrates this, showing expected and 2.5% indexed pension payments.



26. It would be possible to modify a GSA to flatten the late life spike in real income. This would, however be at the expense of the overriding aim to use superannuation for retirement, rather than intergenerational transfer. It would also be possible to smooth out the steps obvious in the chart, but to do this is at the cost of simplicity.

27. MPPL welcomes the statement on page 6 of the paper that there would be no need for guarantees. Guarantees come at a cost. This cost is reflected in the returns to members. The following chart illustrates this cost. It shows, for an annuity quoted by a major provider, for a male aged 70, the combinations of investment return and mortality rates at which the provider breaks even. These combinations are conservative.



28. The conservatism of the assumptions underlying the guaranteed annuity is illustrated by the fact that the annuity that is supported by the MPPL assumptions shown on the chart is 9% higher than that quoted by the provider.

29. MPPL would like future papers' illustrations and examples to include non guaranteed products and would be happy to help Treasury in this respect although it recognises the resources of the Australian Government Actuary could be employed.

30. MPPL agrees that simplicity demands that the "Flagship" CIPR should be a starting point. MPPL recognises the aim of basing different flagships on account balances is to provide a proxy for age pension status. It warns, however, that where the member has a partner, the lack of knowledge about the partner's financial circumstances and the member's other financial assets may reduce the value of account balance as an indicator of age pension status.

31. It would be possible to provide a deferred GSA. This could be done by quarantining a proportion of the initial balance until the deferral age. If the GSA is overlaying an ABP, the minimum drawing arrangements would need to be modified to ensure the funds were quarantined. The ABP overlay, which is MPPL's model, is the simplest to operate and understand.

32. The example of page 8 of the Paper contemplates the trustee setting a default investment option for the ABP. This could flow on to the default for an ABP underlying a Mutual Pension® or other GSA. To address sequencing risk, trustees might wish to offer a "protected" or partially protected investment option. That is, of course, for their decision.

33. An example of a protected investment is the Perennial Value Wealth Defender Australian Shares Trust. While restricted to the Australian Share market, it illustrates the concept. Details are at https://perennial.net.au/our-trusts/wealth-defender/. MPPL has no association with Perennial Asset Management

34. MPPL welcomes the recognition that third party products can be used. Indeed, it is likely that all guaranteed products will be provided by a third party.

35. Issues may arise in the communication between third party providers and members. This will be a matter for trustees to manage. It will be important to establish to which of the fund and the member the third party provider is responsible.

36. Third party providers could be used in GSA arrangements to pool longevity risk of multiple funds. MPPL would like Treasury to publically recognise that pooling is permissible. This would reduce the volatility of each fund's members' longevity protection under a GSA.

37. MPPL agrees that member consent should be required for a CIPR to commence. It suggests that the consent documentation specifically mention the forfeiture issues and require acknowledgment of them.

38. MPPL agrees that longevity protection different from the default CIPR should be available under advice. It notes the already legislated "Innovative" pension changes to the SIS legislation will facilitate this.

39. MPPL considers scaled advice will be difficult for funds to provide. It acknowledges that the responsibility is on trustees to comply with legislation in this respect and this will guide their decision whether to offer scaled advice.

40. MPPL is not convinced of the value of trustees restricting the availability of CIPRs to cohorts for whom they identify CIPRs as unsuitable. Trustees may not have the necessary knowledge of their members' circumstances. It better, in MPPL's opinion, for the CIPR to be offered to all members with adequate description, warnings and disclaimers. Trustees can rely on the fact that the member must give informed consent for the CIPR to commence.

41. One matter not mentioned in the paper but encountered in MPPL's discussions with funds is the issue of uptake by members. While, theoretically, a GSA could operate with two participant members, this is undesirable.

42. Trustees may wish to offer GSA CIPRs that do not commence until a critical mass of participant members is achieved. MPPL suggests that it will be hard for any GSA to be offered unless this is the case.

43. If the CIPR fails to garner sufficient interest, trustees could offer a guaranteed product. By the time it is apparent the guaranteed product is need, its pricing might have changed

44. The final legislation needs to acknowledge and permit participation contingent start ups of CIPRs and reflect the timing and pricing issue.

45. I thank you for the opportunity to make this submission and invite you to contact me should you need to discuss any aspect of it.

Yours sincerely,

Dennis E Barton FIAA
Director